New Constructs®
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DILIGENCE PAYS 3/7/17

Filing Season Finds: Tuesday, March 7

Our latest forensic accounting red flag is from a restaurant operator that reported rosy accounting earnings that weren't matched by real economic profit.

We pulled this highlight from Saturday to Monday's research of 179 10-K filings, from which our robo-analyst technology collected 24,318 data points. Our analyst team used this data to make 4,084 forensic accounting adjustments with a dollar value of $480 billion. The adjustments were applied as follows:

- 1,780 income statement adjustments with a total value of $31 billion
- 1,633 balance sheet adjustments with a total value of $213 billion
- 671 valuation adjustments with a total value of $236 billion

Figure 1: Filing Season Diligence

	Filings Parsed	Data Points Collected	# of Adjustments	Total Value of Adjustments ($Billions)
Saturday-Monday	179	24,318	4,084	$480
Filing Season Total	1,257	183,114	31,184	$11,943

Sources: New Constructs, LLC and company filings.

We believe this research is necessary to close the gap between the suitability and fiduciary standard of investment advice services.

Today's Forensic Accounting Needle In A Haystack Is For Restaurant Investors

Analyst Lindsay Bohannon found an unusual item yesterday in The Habit Restaurants' (HABT: $15/share) 10-K.

HABT leases the majority of its restaurant facilities, as do most companies in the industry. These operating leases constitute a form of off-balance sheet debt that companies will be required to recognize in their financial statements starting in 2018. On page 24 of the footnotes (page 91 overall), we found that the total value of HABT's operating lease obligations increased from $158 million in 2015 to $194 million last year.

Discounted to its present value, HABT's off-balance sheet debt increased by $28 million, or roughly 10% of the firm's invested capital. When we account for this increase in invested capital, we see that HABT's ROIC fell from 8% in 2015 to 6% in 2016. HABT's GAAP earnings may be rising, but its economic earnings are in decline.

This article originally published here on March 7, 2017.

Disclosure: David Trainer, Lindsay Bohannon, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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